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TAGS: EFIN ECON ETRD PGOV RO
SUBJECT: ROMANIAN CENTRAL BANK HIKES INTEREST RATES IN FACE OF
GROWING INFLATION FEARS

Sensitive But Unclassified - please handle accordingly.

SUMMARY

¶1. (SBU) Faced with growing inflationary pressures in the economy, the National Bank of Romania (BNR) raised its benchmark interest rate a half point, from 7.0% to 7.5%, at its October 31 Board of Directors meeting. The hike marked a reversal of the looser monetary policy BNR had pursued since the beginning of the year, and comes in response to mounting signs that inflation this year will exceed the Bank's annual target by perhaps a full percentage point. Markets had anticipated the move, along with the Bank's decision not to change existing minimum reserve requirements for credit institutions. Outside analysts, including the IMF, see the move as reassurance of the central bank's policy independence, but worry that yellow caution signals concerning Romania's growing economic imbalances are beginning to flash a bit more urgently. End summary.

Central Bank Reverses Course

¶2. (U) Local market analysts had anticipated the BNR's October 31 decision to raise its benchmark interest rate by half a point, to 7.5%. The real surprise was that, in the face of rising inflationary pressures, the Bank waited this long to reverse its monetary relaxation policy. BNR had progressively cut rates since February from 8.75% to 7.0%, encouraged by lower inflation in 2006 through early 2007 in connection with the appreciation of the leu against the euro. However, as early as mid-summer it was becoming evident that the Bank would have trouble keeping inflation within the annual target band of 4% plus/minus one percent, particularly as domestic agricultural production suffered from a serious drought. Inflation zoomed to an annualized rate of 6.03% in September, led by steeply rising food and energy prices, very strong domestic wage growth, and an end to the leu's exchange rate gains against the euro.

¶3. (U) In explaining the rate hike, the Bank also cited rising prices of imported food commodities generally and the adverse impact of the exchange rate on Romania's ballooning current account deficit, particularly when viewed against the background of recent turmoil in world financial markets. The Bank also took the unusual step recently of issuing a public call for the GOR to hold spending in check. While analysts say BNR policy has been prudent and credible, and that BNR has been understandably reluctant to fuel more speculative capital inflows by raising interest rates, market conditions forced its hand. By attempting to apply the brakes, BNR also clearly has its eye on persistently strong household

consumption, projected increases in public spending towards the end of the year, and further uncertainty over the leu's rate movements - all of which together will make it impossible to confine inflation within the 5% upper band ceiling.

Darker Clouds on the Economic Horizon?

¶4. (SBU) From a purely political perspective, outside analysts including the IMF were encouraged by the rate hike, as it demonstrates that the BNR is asserting its policy independence at a time when Romania's political cycle would have argued against a monetary tightening. With the country now entering an extended electoral period, beginning with European Parliament elections, politicians would clearly prefer the BNR take no action that could put a damper on economic growth. Still, how much leverage BNR really has over the broader economy - much less GOR fiscal policy - is open to question. That uncertainty is fueling concerns that Romania's economic fundamentals may not be as sound as they appear. Rising inflation, the huge and growing external deficit, and rapidly increasing wages in excess of labor productivity gains are cautionary signals that Romania's recent economic exuberance is becoming unsustainable.

¶5. (SBU) An IMF mission to Romania in late September stressed the heightened vulnerability of Romania's economy and currency to external shocks. The IMF is increasingly concerned about government spending and the lack of a solid medium-term framework for fiscal policy at the Ministry of Economy and Finance. As a result, the IMF is warning that the current account deficit could exceed 15% of GDP by year's end, and recommends the GOR reign in demand by holding the consolidated budget deficit to 2% of GDP in 2007 and 1% in 2008. The GOR may come close in 2007, but no one is expecting it will meet the 2008 recommendation.

¶6. (SBU) Other analysts are similarly expressing caution about Romanian prospects. Standard & Poors cut Romania's outlook this

week to "negative" from "stable" on the basis of BNR's warnings. ABN AMRO predicts that inflation will run above the BNR target into 2008, with further interest rate hikes a real possibility. While higher interest rates would normally be expected to prop up the leu by inviting speculative investment flows, ABN AMRO believes rising investor concerns over exchange rate risk will still push the currency down vis-`-vis the euro in the coming months.

Comment

¶7. (SBU) While by all outward appearances Romania's economic boom continues unabated, the BNR rate hike and rising unease on the part of ratings agencies and the IMF are warning signals that the country may be in for a correction. BNR's action has reinforced perceptions that the Bank is serious about trying to hold inflation in check, and if the leu declines against the euro as analysts are predicting, that would ease the pressure on the current account deficit. Higher interest rates pose other risks, however, and BNR clearly wants the Government to restrain spending so as not to force the Bank into raising rates too much. Romania's ability to weather an external shock is looking rather more precarious, and it may not take much to upset the apple cart.
Taubman